

# QUARTERLY REPORT

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## OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan  
*County Executive*

Bruce Romer  
*Chief Administrative Officer*

August 16, 2006

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended June 30, 2006. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

### History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were an estimated 5,428 active members and 4,815 retirees participating in the ERS as of June 30, 2006.

### Performance Results

The total return achieved by the ERS assets for the quarter was a loss of 1.17%, 20 basis points behind the .97% loss recorded by the policy benchmark. For the one year period ending June 30, the ERS' gross return (before fees) was 9.18%, 22 bpts. ahead of the 8.96% return of the policy benchmark and 1.18% above the 8% actuarial assumed return. The one-year return places the ERS' performance in the top 38% of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was 11.88%, after fees, ranking in the top 20% of the universe. The asset allocation at June 30, 2006 was: Domestic Equities 48.5%, International Equities 17.2%, Fixed Income 22.6%, Inflation Linked Bonds 9.4%, Alternative Investments 1.9%, Real Estate 0.3% and Cash 0.1%.

### Major Initiatives

During the quarter, the Board conducted a search for a currency overlay manager, evaluated the strategic asset allocation/manager funding policies resulting in rebalancing funds between domestic and international equities, selected three firms to act as outside legal counsel, recommended the County Executive consider legislation to bring the ERS into compliance with recently passed State legislation, reviewed the annual brokerage fees paid by ERS managers, and received proxy voting records for actions taken in 2005.

In addition, the Government Finance Officers Association (GFOA) awarded the Board the Certificate of Achievement for its Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2005. The certificate of achievement is a prestigious national award that recognizes conformance with the highest standards in government accounting and financial reporting.

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## Capital Markets and Economic Conditions

The second quarter of 2006 saw a reversal of economic fortunes, following a strong start at the beginning of the year. The first global equity decline in seven quarters occurred through a backdrop of rising inflation expectations, volatile energy prices, central bank uncertainty and general fears of an economic slowdown. The US continues to be a significant driver of global economic progress and the Federal Reserve Bank has a strong focus on managing inflation (with the 17th consecutive interest rate increase in June giving a cumulative 425 basis points of tightening), potentially at the expense of economic growth. Even the Bank of Japan signalled that they were preparing to raise interest rates above zero for the first time in six years. Although developed markets face testing times, emerging markets are generally better positioned to face an economic downturn than in the past, due to stronger financial positions.

The equity markets experienced increased volatility during the quarter, especially during the months of May and June. Value outperformed growth across the capitalization spectrum as investors sought a safe haven. As shown in the chart to the right, the U.S. equity markets lost ground during the quarter with the small capitalization companies represented by the Russell 2000 Index showing the weakest performance, down 5%. In comparison, the S&P 500 Index lost 1.4%. The top performing sectors of the S&P 500 during the quarter were energy and utilities up 3% and 5% respectively, riding on the back of the robust gains in oil prices. Energy stocks like Chevron, Exxon Mobil, and Halliburton contributed to the performance with American Electric Power, Dominion Resources, and PG&E outperforming in utility sector. Underperforming sectors included information technology, down 10%, and healthcare which closed 5% lower.

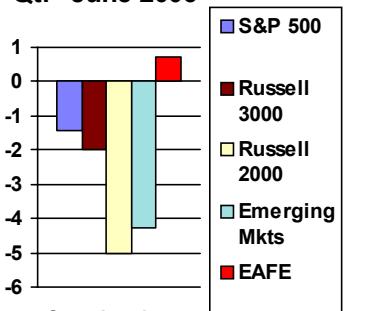
Our combined domestic equity performance was a loss of 2.03%, 5 basis points behind of the Russell 3000 benchmark index return. For the one year period ending June 30, our combined domestic equity performance was 9.87%, 31 basis points ahead of the 9.56% return achieved by the Russell 3000 benchmark index.

Within the international markets, emerging markets were down by 4.3% for the quarter, but up 35.9% for the one year period. Colombia, Turkey, and Egypt markets led decliners during the quarter. Developed international markets were up 0.70% for the quarter as measured by the MSCI EAFE Index. Our combined international equity performance was a loss of 1.46% for the quarter, 167 basis points behind the benchmark index which gained 0.21%. For the one year period ending June 30, our combined international equity performance was 26.1%.

Fixed income market returns were broadly in line over the quarter, with flat returns across government, high yield and non-domestic bonds on a hedged basis. The US dollar declined relative to other major currencies, so unhedged positions benefited. Returns were held back somewhat by ten-year yields continuing to rise across the globe. Emerging market debt was hit the hardest, posting a decline of 2.2% over the quarter. The ERS fixed income return for the period was a loss of 0.16% compared to the loss of 0.10% recorded by the benchmark index. ERS investments in inflation-linked bonds returned .34% for the quarter compared to the benchmark loss of 0.11%. The hawkish tones from the European Central Bank, the Bank of Japan and the Federal Reserve, are very much aligned in keeping inflation in check. A reduction in bond yields will be driven by whether there is a slowing in economic growth.

## Index Returns

Qtr- June 2006



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## Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending June 30, 2006 and fiscal year-to-date.

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### Employees' Retirement System Contributions and Investment Income (millions)

	<u>Qtr 6/30/06</u>	<u>Fiscal YTD</u>
Employer Contributions	\$ 22.1	\$ 88.3
Member Contributions	3.9	16.1
Net Investment Income (Loss)	<u>(28.6)</u>	<u>186.4</u>
	\$ (2.6)	\$290.8

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## Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

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### Employees' Retirement System Deductions by Type (millions)

	<u>QTR 6/30/06</u>	<u>Fiscal YTD</u>
Benefits	\$ 32.5	\$125.8
Refunds	.2	.6
Administrative Expenses	.5	1.9
	<u>\$ 33.2</u>	<u>\$128.3</u>

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## Outlook

Strong economic indicators suggest that the Federal Reserve will continue tightening at its next two Federal Open Market Committee (FOMC) meetings. Because of the weakening in residential investment and housing markets, GDP growth will slow as the next few quarters unfold. This is probably beneficial because it will help keep the economy from overheating. Equity markets should do well in anticipation of an end to the interest rate hikes.

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## EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF PLAN NET ASSETS

June 30, 2006

### Assets

Equity in County's pooled cash and investments	\$ <u>240,192</u>
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Investments	
Northern Trust	2,292,226,773
Aetna	10,787,247
Fidelity - Elected Officials Plan	<u>850,557</u>
Total investments	<u>2,303,864,577</u>
Contributions receivable	<u>6,188,146</u>
Total assets	<u>2,310,292,915</u>

### Liabilities

Benefits payable and other liabilities	<u>3,058,321</u>
Net assets held in trust for pension benefits	\$ <u>2,307,234,594</u>

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**EMPLOYEES' RETIREMENT SYSTEM  
STATEMENTS OF CHANGES IN PLAN NET ASSETS**  
June 30, 2006

<b>Additions</b>	<b>Quarter</b>	<b>Fiscal YTD</b>
Contributions		
Employer	\$22,070,636	\$88,304,152
Members	<u>3,880,774</u>	<u>16,103,176</u>
Total contributions	<u>25,951,410</u>	<u>104,407,328</u>
Investment income (loss)	(26,411,960)	194,317,683
Less investment expenses	<u>2,233,807</u>	<u>7,967,636</u>
Net investment income (loss)	<u>(28,645,767)</u>	<u>186,350,047</u>
Total additions	<u>(2,694,357)</u>	<u>290,757,375</u>
 <b>Deductions</b>		
Retiree benefits	25,676,300	112,209,527
Disability benefits	5,934,213	12,124,706
Survivor benefits	855,433	1,483,035
Refunds	202,968	591,671
Administrative expenses	<u>478,164</u>	<u>1,893,045</u>
Total deductions	<u>33,147,078</u>	<u>128,301,984</u>
 <b>Net increase (decrease)</b>	<u>(35,841,435)</u>	<u>162,455,391</u>
 <b>Net assets held in trust for pension benefits</b>		
Beginning of period	<u>2,343,076,029</u>	<u>2,144,779,203</u>
 <b>End of period</b>	<u><u>\$2,307,234,594</u></u>	<u><u>\$2,307,234,594</u></u>